APPENDIX OF ADDITIONAL ISSUES

1. **The Commission is correct in its tentative conclusion that a BOC may combine some or all of its manufacturing activities, interLATA telecommunications services and interLATA information services in a single separate affiliate.** (272 Notice, ¶ 33) The section 272 requirements refer only to separation from the "operating company"[1] and there is no requirement of separation from another affiliate or separation among the activities regulated by section 272. As the Commission noted, such a conclusion is also supported by the Senate Report on the legislation.

2. **Section 271(h) does not authorize the Commission to impose separation requirements on incidental interLATA services.** (272 Notice, ¶37) Because section 272(a)(2) specifically exempts incidental interLATA services from the section 272 separations requirements, the general language in section 271(h) cannot be read to re-impose such requirements. In fact, section 271(h) does not authorize the Commission to adopt any new regulations. The Commission already has rules in place to protect "telephone exchange service ratepayers."[2] Indeed, by separating prices from regulated costs, pure price cap regulations -- which govern the vast majority of the BOCs -- fully insulate customers of regulated services from any negative impacts, thereby satisfying the requirements of both

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[1] 47 U.S.C. § 272(a)(1)(A).

[2] 47 U.S.C. § 271(h).

section 271(h) and section 254(k). In addition, while unnecessary for price cap regulated companies, the cost allocation rules provide a blunt but effective additional safeguard.

Section 271(h) does provide a basis for a complaint against a BOC that its incidental interLATA service is creating an "adverse impact" on competition. But this right of action does not suggest the need for any rulemaking by the Commission.

3. **Section 272(h) is a catch-all provision that is not intended to require new substantive requirements.** (272 Notice, ¶¶ 34, 38) Section 272(h) merely requires that, to the extent a BOC is already engaged in an activity that would otherwise fall within the requirements of the section 272 regulations, the BOC must bring it into compliance within one year. The Act (section 272(a)(2)B)(iii)), however, specifically exempts previously authorized activities from the section 272 separation requirements. Section 272(h) cannot be read to override that specific exemption.

The Commission asks whether the exception for previously authorized activities was intended to be a "permanent exemption" (see ¶ 38). While the Act places no time limitation on the exemption, the Commission's question ignores the automatic sunset provisions in section 272(f). The separation requirement only has a three year life, so in this sense a "permanent" exemption has a short and defined life.

4. **The definition of "information services" in the Act does not include protocol processing.** (272 Notice, ¶ 42). In contrast to the definition of "enhanced services" in the Commission's

Rules,[3] the information service definition does not explicitly include, and cannot be extended to cover, protocol processing. The information services definition in the statute is limited, in relevant part, to the transforming or processing of information,[4] i.e., the content of the communication as generated by the subscriber. Under the Commission's definition, however, protocol processing does not affect the transmitted information. Instead, "protocols govern the methods used for packaging the transmitted data in quanta, the rules for controlling the flow of information, and the format of headers and trailers surrounding the transmitted information and of separate control messages."[5] Protocol processing neither transforms nor processes information, but merely facilitates its flow through disparate networks. As data networks and services become more sophisticated, customers increasingly demand that their service providers provide seamless interconnections among such services as Switched Multi-Megabit Data Service, Frame Relay, Asynchronous Transfer Mode, and Integrated Services Digital Network Service. The protocol conversions necessary for such interconnection make no changes to the underlying data, but merely format the "envelope" to allow the customers' original data to travel freely among the disparate networks. Such conversions are not, therefore, information services.

5. **InterLATA information services are limited to those in which the BOC's own facilities or services carry the information service itself across LATA boundaries.** (272 Notice,

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[3] 47 C.F.R. § 64.702(a).

[4] 47 U.S.C. § 153(20).

[5] ***Second Computer Inquiry***, 77 F.C.C.2d 384, 420, n.33 (1980).

¶¶43-47, 54). The provisions of Section 271 and 272 were intended to govern the manner in which the BOCs may enter new markets, not to impose more onerous conditions on existing services. In fact, the Act explicitly grandfathers previously-authorized services and excludes them from the Section 272 requirements altogether.[6] The BOCs have offered for some years, consistent with the MFJ, enhanced services, such as telemessaging, in which the end-to-end communications cross LATA boundaries while the service itself is provided within a LATA. Many voice messages that originate in a different LATA from the called party are stored and retrieved in a BOC's voice messaging processor. So long as an interexchange carrier, not the BOC, performs the interLATA transmission of the subscriber's communication, those BOC services have not been, and should not now be, classified as interLATA. It would be inconsistent with Congressional intent, and with the public interest, for the Commission to attempt to sweep existing enhanced service offerings, such as telemessaging services, into the separate subsidiary requirements applicable to interLATA information services. A service that is lawfully being provided pursuant to Commission approval of a comparably efficient interconnection plan or waiver should be presumed to be an intraLATA service for which structural separation is not required (***see*** ¶ 47).

Not only would such a redefinition of existing services as interLATA be inconsistent with statutory intent, it would not serve the public interest. As Bell Atlantic has previously shown, structural separation would significantly increase prices and slash demand for the

[6] 47 U.S.C. § 271(f).

BOCs' popular telemessaging services -- services which millions of consumers currently enjoy.[7]

The Commission should adopt its tentative conclusion that telemessaging is an information service and, if offered on an interLATA basis, is subject to the Section 272(a) separate subsidiary requirements. Such services are not properly classified as interLATA, however, unless the BOC itself provides the interLATA transmission to the customer of the information service.

The definition of an information service as intraLATA should not change if the BOC locates a non-transmission database or processor in another LATA. Such arrangements are considered incidental interLATA services, which, under the Act, are not subject to the separate subsidiary requirements.[8] BOCs, like their competitors, should be able to structure a service in the most operationally efficient manner without converting the service into an interLATA offering.

6. **The Computer II and Computer III Rules are redundant and unnecessary.** (272 Notice, ¶¶ 49-50). Broad provisions in the Communications Act relating to customer proprietary

7 ***See Computer III Further Remand Proceedings: Bell Operating Company Provision of Enhanced Services***, CC Docket No. 95-20, Comments of Bell Atlantic at 7-10, 15-20, App. A and B (Filed April 7, 1995).

8 47 U.S.C. §§ 271(b)(1), 271(g)(4).

network information,[9] network disclosure,[10] nondiscrimination[11] and accounting[12] supplant the Commission's more targeted enhanced service nonstructural safeguards. In addition, the introduction and growth of competition in the local market, along with the application of "pure" price caps, as discussed in the body of this filing, make many of the existing nonstructural safeguards unnecessary, because the BOCs will no longer have an opportunity to cross-subsidize one set of services with others.

7. **Services that cannot clearly be classified either as electronic publishing, or as an exception to the electronic publishing definition, should not arbitrarily be classified as information services.** (272 Notice, ¶ 53) Instead, each service should be examined on its own merits. Some services that cannot be easily categorized might be found to be basic services, or adjunct to basic, while others may in fact be electronic publishing or other services that are not subject to Section 272. It would be inappropriate to categorize all such services on a blanket basis.

8. **No regulations are necessary to implement section 272(b)(4) restrictions on sharing credit between a BOC and a section 272 affiliate.** (272 Notice, ¶ 63) The restriction is clear and specific. The Commission is correct that, to the extent a contract contains a credit

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9 47 U.S.C. § 222.

10 47 U.S.C. § 251 (c)(5).

11 47 U.S.C. §§ 202(a), 272(c)(1).

12 47 U.S.C. §§ 260, 271-276.

provision that violates section 272(b)(4), such a contract would not be allowed under the Act. This prohibition exists under the terms of the Act, however, and does not create the need for additional regulations.

9. **The nondiscrimination standard in section 272(c)(1) can only be fairly read to bar *unreasonable* discrimination.** (272 Notice, ¶ 72-79) The Act makes that clear in section 272(g)(3), which explains that discrimination through permitted joint marketing and sales arrangements do not violate section 272(c)(1). As a theoretical matter, any contract, which in some way excludes other parties could be considered to be a form of discrimination. Such discrimination is reasonable, so long as there is a reasonable economic basis for the contract and, to the extent economically reasonable and otherwise practical, other parties have the opportunity to make similar contracts. Accepting an implicit requirement of unreasonableness into a statutory bar is accepted statutory construction.[13] Regardless of minor language differences, the desired policy result here and in section 202 should be the same -- elimination of unreasonable discrimination.

As with all of section 272's non-accounting safeguards, no additional Commission rules are needed or warranted. Under the statute, the Commission has ample opportunity to ensure that the requirements are met. In addition to any accounting safeguards mandated by the Commission, all transactions between the section 272 affiliate and the BOC must be

[13] ***See, e.g., Northwest Wholesale Stationers, Inc. v. Pacific Stationery & Printing Co.***, 472 U.S. 284, 289 (1985) ("[E]very commercial agreement restrains trade. Whether this action violates § 1 of the Sherman Act depends on whether it is adjudged an ***unreasonable*** restraint." (emphasis in original)

memorialized in documents available for public inspection.[14] Moreover, compliance with section 272 will be the subject of a State/Federal audit every two years.[15] In other words, the Act has already provided "rules necessary to ensure"[16] that all the safeguards of section 272, including those in section 272(c)(1) are implemented.

10. **Sections 272(e)(2) and (4) do not survive the sunset of the section 272 separation requirements.** (272 Notice, ¶¶ 80, 86-87, 89) Under the statute, once the separation requirements sunset, the need for an "interLATA affiliate" disappears. As a result, the related requirements in sections 272(e)(2) and (4), which in part govern the relationship with that affiliate, cease to have any independent meaning. The statutory exception to the sunset provision for subsection (e) refers to parts (1) and (3) of that subsection, which apply regardless of the existence of an affiliate.

11. **The Commission is correct in its conclusion that the requirements of section 272(e)(3) can be met if a long distance affiliate purchases access from a tariff or by imputing access rates to the BOCs own interLATA service.** (272 Notice, ¶¶ 80, 88) The statute requires that the affiliated long distance provider must pay -- either explicitly or implicitly -- an amount equivalent to the access charged to third parties. This requirement can be met by having the 272 affiliate buy access off an existing tariff, or, if the affiliate purchases an end-

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[14] 47 U.S.C. § 272(b)(5).

[15] 47 U.S.C. § 272(d).

[16] 272 Notice, ¶ 77.

to-end service, the BOC must impute to itself an amount equivalent to access and those amounts must be included in the overall end-to-end rate charged to the affiliate. No additional regulations are necessary to implement this requirement. The Commission or any other interested party will have the right to review the public writing that section 272(b)(5) requires be available and, if appropriate, an enforcement action can be brought if the transaction fails to meet any of the section 272 requirements, including subsection (e)(3).

12. **The Act already provides mechanisms necessary to facilitate detection of violations of the section 272 safeguards and no additional regulations are necessary.** (272 Notice, ¶¶ 91-96) The Act provides for third party enforcement, through the section 271(d)(6) complaint process, or independent Commission enforcement. In addition to the watchful eye of BOC competitors, the Commission will also have the opportunity to audit compliance every two years.[17] Again, the Act anticipated the Commission's concerns,[18] and provided a balanced answer that requires no further regulation.

The responsibility for making written record of transactions with affiliates publicly available falls on the BOC, not on the Commission.[19] Bell Atlantic will ensure that a copy of any such transaction agreement is readily available to the public. Bell Atlantic would, as a matter of course, make the Commission aware of qualifying transaction agreement.

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17 47 U.S.C. § 272(d).

18 272 Notice, ¶ 94.

19 See 272 Notice, ¶ 96; 47 U.S.C. § 272(b)(5).

EXHIBIT 2

BEFORE THE

FEDERAL COMMUNICATIONS COMMISSION

WASHINGTON, D.C. 20554

In the matter of	)	
	)	
Implementation of the Non-Accounting Safeguards of Sections 271 and 272 of the Communications Act of 1934, as amended;	)	**CC Docket No. 96-149**
	)	
and	)	
	)	
Regulatory Treatment of LEC Provision of Interexchange Services Originating in the LEC's Local Exchange Area	)	

AFFIDAVIT OF WILLIAM E. TAYLOR

1. I am Senior Vice President of National Economic Research Associates, Inc. (NERA), head of its telecommunications economics practice and head of its Cambridge office. My business address is One Main Street, Cambridge, Massachusetts 02142.

2. I have been an economist for over twenty-five years. I received a B.A. degree in economics (Magna Cum Laude) from Harvard College in 1968, a master's degree in statistics from the University of California at Berkeley in 1970, and a Ph.D. in Economics from Berkeley in 1974, specializing in industrial organization and econometrics. I have taught and published research in the areas of microeconomics, theoretical and applied econometrics, and telecommunications policy at academic institutions (including the economics departments of Cornell University, the Catholic University of Louvain in Belgium, and the Massachusetts Institute of Technology) and at research organizations in the telecommunications industry (including Bell Laboratories and Bell

Communications Research, Inc.). I have participated in telecommunications regulatory proceedings before state public service commissions and the Federal Communications Commission (FCC) concerning competition, incentive regulation, price cap regulation, productivity, access charges, pricing for economic efficiency, and cost allocation methods for joint supply of video, voice and data services on broadband networks. A copy of my vita was provided as an attachment to my affidavit filed on behalf of Bell Atlantic and other parties in CC Docket No. 96-46 on April 26, 1996.

I. SUMMARY AND CONCLUSIONS

3. In its Notice of Proposed Rulemaking CC Docket No. 96-149,[1] the FCC asks for comments on proposed rules to implement Section 272 of the Telecommunications Act of 1996 (the Act) and for comments on whether the BOCs' long distance affiliates should be classified as dominant or non-dominant when they provide in-region long distance service.

4. Regarding the former, any potential problems the Commission may perceive as a result of a BOC's status as a local exchange incumbent are already addressed by the Act itself and the Commission's existing regulations. Additional regulations in these areas—particularly proposals that are more onerous than the Act requires and more onerous even than the Computer II rules—are likely to raise costs, distort competition and raise prices to consumers . Regarding the latter, dominant firm regulation of a BOC's long distance affiliate is unnecessary and counterproductive because there is no threat that such affiliates will have market power in a properly defined national long distance market. Dominant firm regulation, when it is not necessary, is not benign; imposing such regulation on the BOC long distance affiliates would discourage price competition and the introduction of new services, leading to higher prices and slower supply of new services to consumers.

[1] Implementation of the Non-Accounting Safeguards of Sections 271 and 272 of the Communications Act of 1934, as amended; and Regulatory Treatment of LEC Provision of Interexchange Services Originating in the LEC's Local Exchange Area, *Notice of Proposed Rulemaking*, CC Docket No. 96-149, released July 18, 1996 (NPRM).

II. SECTION 272 ISSUES

5. From an economic standpoint, the FCC's proposals to implement the safeguard provisions in Section 272 of the Act are, in a number of respects, both unnecessary and counterproductive. This is especially true to the extent the proposed rules are more stringent than those the Act appears to require and more stringent even than the FCC's own Computer II rules. In particular, experience under existing non-structural rules shows that banning the sharing of functions and services between regulated and unregulated affiliates is unnecessary. These restrictions would also be costly to consumers: distorting competition in the long distance market, raising the cost of the BOC and its affiliate, and denying customers the benefits of the economies of scope from joint supply of local exchange and long distance services.

6. Section 272(b)(3) of the Act requires that affiliates must have separate "officers, directors, and employees" from the affiliated BOC. Under its *Computer II* decision, however, the FCC has permitted sharing of certain administrative services (e.g., accounting, auditing, legal, personnel recruitment and management, finance, tax insurance and pension services).[2] The NPRM tentatively concludes that sharing such functions in-house should be prohibited and even seeks comment on whether a BOC and its affiliate can use the same external suppliers for these services (NPRM at ¶ 62). This proposed repudiation of the FCC's previous standards is surprising. It does not appear to be required by the letter of the Act, which simply mandates that the BOC and its affiliate not share <u>employees</u>; nothing is said to preclude sharing functions or services. And from an economic perspective, this distinction between employees and services is particularly important, because it is just this type of sharing of functions to preserve economies of scope for which the separate subsidiary structure was designed.[3]

7. The administrative functions outlined above are particularly suited for sharing across affiliate boundaries, as evidenced from the fact that these functions are frequently provided to telephone

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[2] See *Computer II Reconsideration Order*, 84 FCC 2d 50, 84, at ¶ 102.

[3] Sharing, in this description, includes the provision of services to both the local and long distance organizations through a centralized service organization.

companies—and other purchasers—by outside suppliers. Where there are economies of scope, however, in the provision of these functions, denying these economies to the BOC and its affiliate will raise costs of service for both suppliers, and, in competitive markets, ultimately raise the prices paid by consumers. Other competitors bring their own unique economies of scope to the local and local distance markets: IXCs have long distance networks and switches in place, CAPs have local networks, cable television suppliers have residential local networks and a broadband backbone. Efficient competition among these networks requires that each be able to take advantage of its natural scope economies. The Commission's existing rules have proven effective with respect to both discrimination and cross-subsidization in an environment where sharing functions and services among affiliates is permitted. Restricting the BOCs from taking advantage of this opportunity to reduce costs would lead to inefficient competition, higher prices, and reduced economic welfare.

8. While quantification of the cost of the proposed restrictions is difficult and dependent upon the circumstances of the particular affiliate relationship, some bounds can readily be calculated. For all LECs, general and administrative costs average about 15 percent of total operating expenses.[4] In the extreme, if the prohibition against sharing administrative expenses required complete duplication of administrative functions between the LEC and its affiliate and if those administrative expenses were essentially volume insensitive, the result would be to increase the affiliate's unit costs by 15 percent.[5] Imposing higher costs on a new entrant—or any firm—by requiring the unnecessary duplication of functions reduces economic welfare and is a costly public policy. Scarce economic resources are wasted on every unit of service the entrant sells, and the customers the entrant attracts pay a higher price than they would if the entrant were allowed to take full advantage of its scope economies. The Commission should not create such inefficiencies in these circumstances where the safeguards are redundant.

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[4] Data from Table 2.9 of the FCC's *Statistics of Communications Common Carriers*, December 31, 1994.

[5] Of course, this figure is an upper bound. Some administrative functions will have to be duplicated irrespective of the rules, and complete sharing of administrative functions between the LEC and its affiliate would increase administrative expenses to some degree beyond their level of the LEC alone.

9. This review of the potential costs imposed by the Commission's proposal here is conservative in two respects. First, it ignores the cost to consumers of service offerings that would be delayed or not take place at all because of the restrictions. Welfare losses from withholding such services can be much larger than the direct costs of the regulatory restrictions estimated here. Second, it does not take into account additional costs that could be imposed by other unnecessary restrictions. Adoption of any unnecessary regulation burdens competition and, ultimately, consumers.

III. CLASSIFICATION OF CARRIERS AS NON-DOMINANT

10. In a series of orders spanning decades, the Commission has distinguished two kinds of carriers—dominant carriers (those with market power) and non-dominant carriers (those without). When a carrier is classified as non-dominant, it is freed from regulatory burdens that the dominant carrier bears, including price regulation, advance tariff filing requirements, notification of construction plans under Section 214 and cost reporting. The FCC recently has decided that the largest interexchange carrier, AT&T, is non-dominant in the interstate, domestic, interexchange domestic market and all international markets.[6]

11. Classification of any carrier as dominant imposes costs on consumers as well as on the dominant firm. The FCC has recognized some of these costs in its consideration of non-dominant treatment for AT&T:

> The cost of dominant carrier regulation of AT&T in this context includes inhibiting AT&T from quickly introducing new services and from quickly responding to new offerings by its rivals. This occurs because of the longer tariff notice requirements imposed on AT&T, which allow AT&T's competitors to respond to AT&T tariff filings covering new services and promotions even before AT&T's tariffs become effective. The longer notice requirements imposed on AT&T thus also reduce the incentive for AT&T to initiate price reductions. In addition, to the extent AT&T were to initiate such strategies, AT&T's competitors could use the regulatory process to delay, and consequently, ultimately thwart

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[6] Motion of AT&T Corp. to be Reclassified as a Non-Dominant Carrier, *Order*, 11 FCC Rcd 3271 (1996), released October 23, 1995 (domestic) and May 9, 1996 (international) ("AT&T Non-Dominant Order").

> AT&T's strategies. Furthermore, such regulation imposes compliance costs on AT&T and administrative costs on the Commission.[7]

The same point was raised by AT&T in that proceeding:

> AT&T argues that continuing to regulate it as a dominant carrier imposes direct costs on carriers and customers, and does not facilitate a competitive market for interstate, domestic, interexchange services. AT&T claims that, despite loss of market power, it continues to be subjected to "burdensome and unequal" regulation that unfairly advantages its competitors and deprives consumers of price reductions and innovative service offerings.[8]

12. As a matter of economics, asymmetric regulation applied to firms classified as dominant is likely to distort the competitive process in the market and reduce the benefits of competition to consumers. In the current context, the BOC affiliates enter the market with no market share to compete against some of the largest telecommunications firms in the world which have served these markets since the invention of the telephone, whose names are household words throughout the globe, and who currently provide service to essentially all potential customers in the market. Classifying a BOC long distance affiliate as dominant in this market would be poor English, poor economics, and poor public policy. Restricting the pricing of a BOC long distance affiliate would risk perpetuating the umbrella pricing for long distance service which has characterized the market while AT&T was regulated as a dominant carrier and reduced the vigor of price competition particularly as seen by residential and small business customers.

A. Market Power and Market Definition

13. In ¶ 114, the NPRM correctly identifies the regulatory concept of dominance with the economic concept of market power and observes that the first step is the market power analysis described in the Department of Justice and Federal Trade Commission's *Merger Guidelines*.[9]

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[7] *Ibid.*, ¶ 27.

[8] *Ibid.*, ¶ 16.

[9] United States Department of Justice and Federal Trade Commission, *Horizontal Merger Guidelines*, April 2, 1992 (Merger Guidelines). Market power is defined as the ability of a firm profitably to raise the price (or reduce the quality) of a product or group of products above the level that would pertain under competitive circumstances. Market power is the proper focus of regulatory concern because (i) exploitation of market power reduces economic

(continued...)

Market power is a meaningful concept only in the context of an economic market, and such markets have both service and geographic components. The NPRM considers narrowing both the product and geographic market definitions the FCC has previously applied in its Competitive Carrier decisions to the long distance market. It is correct in its rejection of a more narrow product market definition, tentatively concluding that the relevant product market contains "all interstate, domestic interLATA telecommunications services" (¶ 119). It is incorrect in its tentative conclusion that the relevant geographic market "should be defined as all calls from one particular location to another particular location" (¶ 124) and, especially, that it should

> evaluate a BOC's point-to-point markets in which calls originate in-region separately from its point-to-point markets in which calls originate out of region, for the purpose of determining whether a BOC interLATA affiliate posses market power in the provision of in-region, interstate, domestic, interLATA services (¶ 126).

In both cases, the NPRM deviates from strict economic analysis by asking whether a change in market definition from past practice is warranted to assess whether a BOC or LEC affiliate has market power (¶¶ 119, 125). The boundaries of a market determine the products and geographic areas within which firms compete with one another for customers. All such firms compete within the same market boundaries, and if a more narrow market definition is appropriate after the entry of BOC or LEC affiliates into interLATA markets, that same market definition must apply to all firms for the purpose of calculating market power.

1. Product Market

14. An economic product market is a set of products or services which includes all close substitutes so that if a single firm controlled the sale of these services, it could profitably hold the price above the competitive market level. The *Merger Guidelines* define a product market as

(...continued)

welfare (i.e., the sum of producers and consumers surplus), and (ii) possession of market power is necessary for a firm to benefit from restricting competition in any market. See, e.g., J. Tirole, *The Theory of Industrial Organization*, Cambridge: MIT Press, 1988, pp. 137-139.

> a product or group of products such that a hypothetical profit-maximizing firm that was the only present and future seller of those products likely would impose at least a small but significant and non-transitory increase in price.[10]

Mechanically, the *Merger Guidelines* define the scope of the product market in terms of demand substitution, but in assessing market power within such a market, the Guidelines explicitly include both demand substitution and the supply response of potential competitors.

15. Applied to telecommunications markets where the same basic network capacity can be used to provide many different services, the product market thus includes the full set of interstate domestic interexchange telecommunications services as the NPRM tentatively concludes in ¶ 119.

2. Geographic Market

16. The *Merger Guidelines* defines the geographic market for a service as the area within which a single supplier of a service could profitably maintain price above the competitive level without encouraging customers to substitute towards services provided by firms in other areas:

> the geographic market [is] a region such that a hypothetical monopolist that was the only present or future producer of the relevant product at locations in that region would profitably impose at least a 'small but significant and non-transitory' increase in price, holding constant the terms of sale for all products produced elsewhere.[11]

Using this definition, there has been consistent agreement among students of the industry that the interstate long distance market is national in scope. Even though customers want to place calls to specific locations, they find it advantageous to purchase services on a nationwide basis, generally at prices that do not differ depending on the originating and terminating location. Similarly, suppliers find it advantageous to sell their services on the same basis, with little or no geographic diversity in their offered prices.

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[10] *Merger Guidelines*, Section 1.11. The threshold size and duration of the price increase generally considered by the Department of Justice when using the definition is a five to ten percent increase in price lasting for at least two years.

[11] *Merger Guidelines*, at p. 16.

17. In defining the geographic market for a BOC long distance affiliate, however, the NPRM raises a new issue:

> it is possible that a BOC, through cost misallocation or discrimination, may be able to use its market power in local exchange and exchange access services to disadvantage the BOC affiliate's interexchange competitors...With respect to each originating in-region location, the determination of whether a BOC affiliate or independent LEC possesses market power in that market will turn on the same issue – whether the BOC or independent LEC can leverage the market power arising from its control of access facilities sufficiently to give the BOC affiliate or independent LEC affiliate, respectively, market power in that point-to-point market in the provision of interstate ...services (NPRM ¶ 125)

from which it tentatively concludes that it should treat as distinct geographic markets a BOC affiliate's point-to-point markets for calls originating in-region and its point-to-point markets for calls originating out-of-region (¶ 126).

18. There are three apparent problems with this tentative conclusion. First, it suggests that a "market" belongs to a particular firm: i.e., that one market definition is correct for AT&T, MCI and Sprint but a different market definition applies to BOC interLATA affiliates. This is incorrect. An economic market characterizes the arena—in product and geographic dimensions—in which competition takes place. To define the market, the Merger Guidelines envision a hypothetical firm and asks what sets of products or services or geographic areas would be necessary to control in order for the firm to control price. The market definition that emerges from that process manifestly pertains to the market, not to particular competitors.

19. There is no suggestion that a BOC affiliate's in-region long distance service could be so unique and valuable to end-users that a firm that monopolized that particular service in a region could profitably hold price above the competitive level. Nonetheless, if the economic characteristics of long distance services were so changed by the entry of LEC affiliates that regional or city-pair markets emerged, then those would be the markets in which market power for all participants would have to be measured. In the case of interLATA services, the applicable product market would include all interLATA services regardless of the service provider, and the corresponding geographic market is national in scope regardless of the service provider. This

tentative proposal to define the interstate, domestic, interexchange market more narrowly for local exchange carriers than for interexchange carriers is closer to economic gerrymandering than economic market definition. Whatever the market definition, it must be the same for all competitors.

20. Second, a point-to-point market definition is not consistent with the marketplace. A city-pair is not an economic market because long distance service is neither bought nor sold on a city-pair basis. Customers contract—indeed, subscribe—with a provider of interLATA services for nationwide service; multiple interLATA service providers are not used for different point-to-point routes. Customers place calls between a variety of city pairs and—like left and right shoes—buy from a single supplier of all city pairs.[12] Suppliers do not incur the costs of advertising and separately tariffing services by city pair, and the recent tendency in long-distance competition has been toward single postalized rates. Such pricing structures are easy to communicate to end-users and apparently render a competitive advantage in serving some customers. If long distance carriers could earn higher profits by pricing city-pairs individually, then we would have observed that outcome in the market, but that is not an observable pricing strategy for any long distance carrier.

21. It is reasonable to assume that BOC long distance affiliates would have to market their services to customers in the same way that interexchange carriers do—as a single national package rather than as many individual city-pairs. Thus, even if a BOC affiliate—by virtue of the BOC's so-called bottleneck control of access services—possessed an advantage over its long distance competitors in originating traffic in-region, that advantage would have to be sufficiently significant in the context of a national long distance market to attract customers in order that the BOC affiliate could profitably hold its geographically-averaged price above the market level.

[12] This feature distinguishes telephone geographic markets from airline geographic markets which were cited (footnote 228) in the NPRM as examples of point-to-point markets. U.S. domestic airlines specialize in particular city-pair routes and no carrier serves all U.S. city-pairs. In addition, prices and costs in the airline market vary with distance to a much greater extent than in the long distance market.

22. In addition, this market definition exercise must be undertaken in the markets not as they are but as they will be when the BOC affiliate in question is authorized to provide interLATA services in-region. In these markets, the BOC will supply traditional equal access to all long distance competitors under the Commission's established rules barring discrimination and will charge its own long distance affiliate the same price for access as it charges all other long distance providers. Moreover, the BOC generally will be subject to price caps rather than rate of return regulation and will provide unbundled network elements or resold local exchange services to long distance and local exchange competitors. Under these circumstances, neither the BOC affiliate nor anyone else can profitably hold price for traffic originating in-region above the price determined in the national long distance market; hence, in-region originating traffic does not constitute a proper geographic market.

23. Third, regulatory and judicial precedent has consistently recognized the national character of U.S. long distance markets. In the FCC's recent decision to classify AT&T as non-dominant, it defined the product component of the relevant market to include all interstate, interexchange services. An additional supply-side analysis found that the excess capacity in long distance networks and the fungibility of that capacity across routes mandated a national market definition. A hypothetical monopolist of long distance facilities between Philadelphia and Washington, DC would be unable to hold price above cost because the fungibility of long distance network capacity means that capacity elsewhere and in other networks can be instantly used to transport traffic between those points. The FCC has found that regulation based on city pairs would be "impracticable to conduct … in each geographic market implied by a point-to-point market definition"[13] and would impose regulatory costs that would provide little or no benefit to consumers, particularly in light of its penchant for geographic averaging of long distance rates.

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[13] Policy and Rules Concerning the Interstate Interexchange Marketplace: Implementation of Section 254(g) of the Communications Act of 1934, CC Docket 96-61, *Notice of Proposed Rulemaking*, (released March25, 1996) at ¶ 50.

B. Classification of BOC Long Distance Affiliates

24. Formally, to classify a LEC as non-dominant for a relevant market, we must consider the substitutes available in the interstate, domestic, interexchange markets, markets containing hundreds of firms providing homogenous services, predominantly served by three large global competitors. We must determine whether competition is sufficiently vigorous—and thus the corresponding market constraints sufficiently tight—that treatment as a non-dominant provider is in order. Existing competitors in the interLATA market provide significant constraints on LEC pricing in the interstate, domestic, interexchange market (either in-region or out-of-region, or both). In its recent reclassification of AT&T as non-dominant in the supply of domestic long-distance services, the FCC adopted a wide geographic and product market definition and found that, on the whole, AT&T did not possess significant market power in that market. That is, customers had sufficient ability to substitute away from AT&T service that it had no significant power to raise price. Holding aside for the moment the issue of market power in the local exchange, LEC affiliate entry into long distance will only increase customers' range of choices. Moreover, LEC affiliates will enter that market in-region or out-of-region with no current customers. Since (nearly) all households and businesses subscribe to telephone service and have a current long distance carrier, LEC affiliate entrants will have to attract customers away from their current suppliers. The same logic that concluded that customers had sufficient choice of suppliers in the long distance market to classify AT&T as non-dominant requires that increased customer choice should be sufficient to classify other, smaller competitors as non-dominant. Note also that AT&T's classification took place despite AT&T's strength in related telecommunications markets—wireless and equipment manufacturing. Applying that same analysis to the this case—and still holding aside the question of any local exchange market power—it is clear that LECs should be classified as non-dominant in this market.

25. Economists are careful to point out that continued regulation has very real costs in telecommunications markets, and if an error must be made, it should generally be made in favor of reduced regulation rather than continued unnecessary regulation. An example of such regulation is the tariff filing requirements that pertained to AT&T as a dominant carrier and the

inadvertent effect of those requirements to facilitate tacit price coordination among the large IXCs. In its Non-Dominant Order, the FCC notes that

> the evidence in the record is conflicting and inconclusive as to the issue of tacit price coordination among AT&T, MCI and Sprint with respect to basic schedule rates or residential rates in general ... We believe, however, that this problem, to the extent it may exist, is a problem generic to the interexchange industry and not specific to AT&T. We thus believe these concerns are better addressed by removing regulatory requirements that may facilitate such conduct, such as the longer advance notice period currently applicable only to AT&T...[14]

Over-regulation is not benign, and uncertainty in its application should be resolved in favor of less, rather than more.

26. The remaining question is whether a BOC affiliate should be classified as dominant because of the BOC's status as a local exchange incumbent (NPRM, ¶ 16). The NPRM identifies two problems associated with the control of local exchange access facilities by a long distance supplier: (i) the improper allocation of costs and (ii) the possibility of unlawful discrimination (NPRM ¶ 134).

1. Cross-Subsidy and Market Power

27. While the potential exercise of market power in local exchange markets is a legitimate concern in the regulation of local exchange markets, there is no economic reason why the possession of such market power should affect the analysis of market power in the downstream retail long distance market. In the first place, it cannot be assumed that a BOC that supplies interLATA services in-region retains significant market power for carrier access services. Under the Act, supply of interLATA services is contingent upon a showing that the local exchange market is open to competition, and the BOC must be so certified by its state regulator. Once the checklist is met, all barriers to entry into the supply of local exchange service will have been removed by the LEC's mandatory provision of interconnection with competing networks,

[14] AT&T Non-Dominant Order, at ¶ 83.

unbundled network elements and retail services for resale at wholesale rates. In addition, other structural characteristics of the industry have changed since the imposition of the Modification of Final Judgment in 1984: over a decade of equal access provision and five years of price regulation have greatly reduced the prospect of LEC cross-subsidization and discrimination.

28. Second, market power upstream does not translate into market power—or market advantage—downstream. In the interLATA market, BOCs are required by the Act to impute their carrier access charges into their long distance prices, so that all competitors effectively pay the same price for carrier access.[15] A BOC's long distance affiliate in the future would purchase carrier access in the same manner as its competitors—paying the same price under the same terms and conditions—so that any exploitation of market power in carrier access would affect all competitors in the downstream long distance business equally. While the hypothetical exercise of market power in the local exchange market could enable the BOC affiliate to raise <u>all</u> competitors' costs in the long distance market, even bottleneck control of carrier access services could not increase rivals' costs relative to those of its own affiliate. And price regulation of carrier access service would properly prevent any exercise of market power for those services in the first place.

29. Third, there is no additional market power that derives from the vertical relationship between local exchange access and long distance beyond that possessed by the BOC in the local exchange market. Generally, market power can be exploited only once in a vertical relationship,[16] and the theoretical exceptions to this rule do not apply to a long distance affiliate of a local exchange supplier. Access and interLATA services are supplied in fixed proportions so the BOC affiliate has no cost advantage over its rivals. Because BOC carrier access services are price-capped, the BOC cannot shift profits into the long distance market to escape local exchange regulation. And finally, the fact that the BOC must deal with its affiliate and the affiliate's competitors under

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[15] Act 272(e)(3).

[16] See, e.g., D.W. Carlton and J.M. Perloff, *Modern Industrial Organization*, New York: Harper-Collins, 1990, Chapter 16.

identical terms and conditions rules out any competitive advantage in the long distance market from the ownership of carrier access facilities.

30. Fourth, presence of BOC market power in local exchange access may require regulation of that service to prevent cross-subsidization and discrimination, but there is no additional role that regulation of the BOC long distance affiliate would serve. The conditions under which a BOC affiliate could profitably raise its long distance price above the competitive level are the same as those that apply to AT&T: that is, that customers be unable to substitute away from the BOC's service in sufficient number to render the price increase unprofitable. The ability of a BOC affiliate to profit from a price squeeze or other discriminatory treatment of its long distance competitors is the same as AT&T's ability to profit from predatory pricing.[17] It is impossible that a BOC strategy of predation or a price squeeze would be remotely successful. First, every BOC is small relative to AT&T and would have little prospect of driving it or any other nationwide facilities-based interexchange carrier from the interLATA market. Second, even if it succeeded, the competitors' optical fiber networks would remain in place so that when the BOC attempted to raise price and recoup its losses, there would be no barrier to re-entry and no ability to recoup. Thus there is no role to be played by regulation of the BOC affiliate's long distance service beyond whatever regulation may be necessary of the BOC's local exchange access service. Additional control over prices or terms of supply in the long distance market is redundant and useless as a regulatory tool to control possible problems in the local exchange market, and such mis-placed regulation runs the risk of suppressing competition in the downstream long distance market.

2. Discrimination

31. Finally, the classification of a BOC long distance affiliate as a dominant interLATA supplier presupposes an ability to discriminate in the local exchange market that defies both theory and

[17] In both cases, the predatory firm sacrifices current profits in the expectation of driving rivals from the market and recouping its losses from future price increases when market power has increased. To succeed, both firms would need to have a realistic prospect of achieving market power in the future and keeping it, which requires barriers to entry as well as the ability to control price.